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Q2 2021

European Equity Barometer

Insights from the Fundamental Equities Team

Economic activity continues to rebound and optimistic narratives have gripped the market so far in 2021. We see inflationary pressures in the near-term causing a mechanical de-rating of higher growth stocks. However, our long-term view remains unchanged: this is not likely a new market regime, but and interlude to low, but stable, growth, inflation and interest rates in Europe.

Despite vaccine roll-out concerns, Europe and its consumers remain resilient

Inflation pressures are here, but we believe they are broadly transitory

The market has rotated significantly, some defensives look more attractive at the margin

BlackRock's Fundamental European Equity team

18 Investors

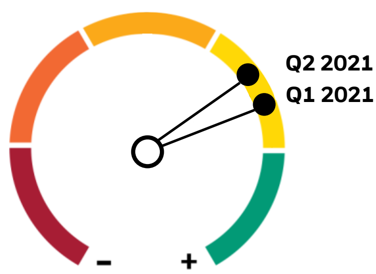
1 Data scientist

> 230 years of experience

Market overview and outlook

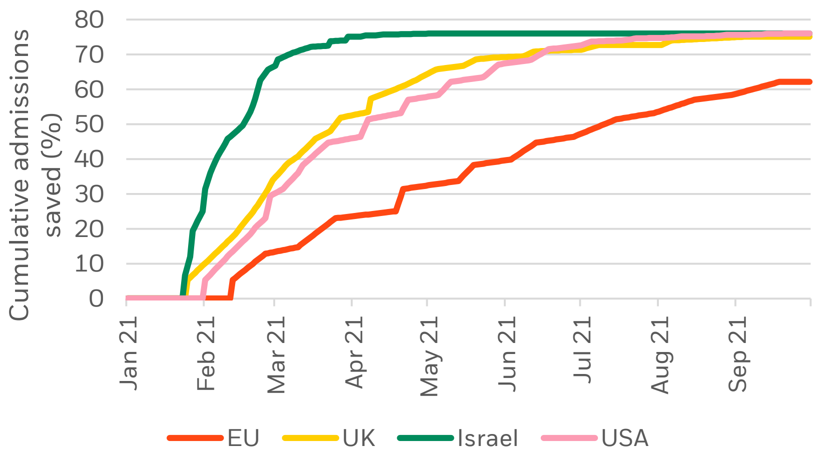
Politics and the disappointing vaccine roll out thus far has somewhat weighed on returns for European equities. However, we don't see meaningful evidence that this has changed companies' outlooks and remain optimistic on the potential impact of vaccines (see chart below). European equities are international in their revenue pools. We see continued opportunity for earnings upgrades, particularly from companies with strong execution and more structural cost cutting capabilities. Through Q1 we took the opportunity to trim certain cyclicals accumulated through H2 2020, and at the margin are now seeing opportunities in more defensive businesses as valuations become more compelling and markets and economies begin to normalise to trend growth. This may mean there is perhaps be less 'factor' or sector dispersion in returns going forward.

Conviction gauge



We have devised a schematic to illustrate the current strength of our conviction on the market and how that has changed since last quarter. Far right is the strongest, or most positive, reading and far left the weakest, or most negative, reading. The middle position equals neutral.

Anticipated fall in hospital occupancy due to vaccine campaign



Source: BlackRock estimates, 23 January 2021. The data assumes one shot efficacy of 70% and two shot efficacy of 95% with an 80% adoption rate, a five-week lag to hospital admissions. The data is based on roll out rates at the time of writing. For the EU, the current roll out will lead to 8% of the population being vaccinated by 31 March 2021. We then assume 10% of the population are vaccinated per month with one dose. For the UK and USA, the current rate is 15% of the population per month. For Israel, the current rate is 30% of the population per month. There is no guarantee that any forecasts made will come to pass.

1 Looking at the margin

Earnings have been revived; the Q4 reporting season showed the broadest beat for European earnings versus expectations since 2007. This is to be expected, as despite continued lockdowns in certain economies, we continue to learn how to adapt and, to an extent, live with the Covid-19 virus. Indeed, even Europe's slower than anticipated vaccine roll out doesn't seem to have meaningfully weighed on company expectations overall.

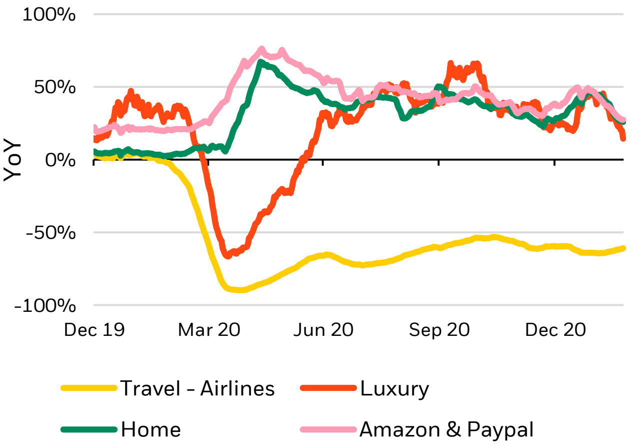
Two primary dynamics have driven the positive earnings momentum in Europe: cyclical resurgence and margin beats. The former, again, is to be expected. Demand has accelerated across end markets such as construction, infrastructure and autos and government stimulus, including furlough schemes, continues to temper any broader default cycle. The latter has been supported by aggressive cost cutting actions companies have taken in response to Covid-19 and 2020's market downturn. This has improved corporate health; cash on MSCI Europe company balance sheets rose to a record 13% of assets in 2020. Such a backdrop improves the outlook for, capex and shareholder capital return and M&A as companies aim to reposition their business. We see this as constructive for the market in the medium term.

However, many cost cuts are transitory and cyclical tailwinds may come to an end. As long term investors, much of our energy is spent on understanding the long term durability of a company's return profile. Whilst cost cutting in many businesses may be temporary, we note some clear examples of structural change which can improve cash conversion, a point heard from a number of companies through full year roadshows. Companies that have the flexibility to more permanently reduce costs through less office space, technology and overall efficiencies stand in good stead.

2 Consumer boom

The clearest example of how this downturn has been different, in an economic sense, to those that have come before it is the consumer's profile. Over the last year we have seen aggregate disposable incomes rise, house prices increase and excess savings ratios boom. The consumer balance sheet is exceptionally healthy. Barriers to spending have clearly been a driver, whilst a feeling of greater wealth has buoyed e-commerce, luxury goods and home-improvement.

Fig 2: Tracking US spending patterns



Source: BlackRock, FE Alternative Data, Mar 21

We have closely tracked consumer spending and sentiment through alternative data over recent years (Figure 2). Sources such as credit card data, web-traffic, search trends and mobility data have provided us near real-time information on the consumer. The latest data on European DIY suggests momentum continues, whilst the 2 year stack on certain luxury goods brands provide some assurances that the outlook remains strong. However, with a more sustained re-opening we expect a clear shift in spend for services. As we saw through the summer of 2020, the propensity to spend on restaurants and travel is high. With rising demand, lost revenues to re-gain and tighter capacity owing to continued social distancing, we may expect some services inflation to materalise as a result.

A final observation on the European consumer: a change in market participation. European consumers have historically been reticent to invest in equity markets. Greater disposal income and more time at home has changed that. Upgrades from investment platforms such as Hargreaves Lansdown, AJ Bell, Plus500 and IG illustrate this greater trading activity and market participation.

3 Fundamentals of energy

A cyclical upturn paired with supply demand imbalance has driven oil prices higher year-to-date. We see the underlying fundamentals of supply and demand, although predicated on the actions of OPEC, likely to support the oil price in the near-term. Oil demand has recovered towards peak levels, ex-jet fuel, with clear further demand as jet fuel recovers later in the year. In the longer-term, we believe the potential to reach peak oil demand within the next 5 years likely weighs on potential for a duration up cycle for energy.

Predicting moves in the oil price over multiple time horizons, however, is notoriously challenging and something we don't deem to be within our core skill set. When investing, we care more for the trajectory and sustainability of returns and cashflows. Whilst energy stocks may be getting a boost from the higher oil price, we see evidence of a deterioration of their longer-term returns outlook. Big oil companies have set out ambitions to pivot to a lower carbon world for some time. Within this, it has made sense to pursue offshore wind projects given scale potential and relevant skills in engineering and seabed expertise. The latest UK Crown Estate seabed auction has highlighted just how far these oil majors are willing to go to gain a foothold in these markets. 60% of the auctions were won by oil majors with fees paid notably above the previous market level. This is likely to compress the return rates on these projects for all participants, unless offset by meaningful higher power prices for the merchant, and eventually consumer. We are cautious on activity within this sector, favouring companies with strong execution and more disciplined capital allocation to create value over the long-term.

> **“We care more for the trajectory and sustainability of returns and cashflows”**

Weighing up inflation

Inflation and rate expectations have been meaningful drivers of market returns and leadership year-to-date. The return registered by MSCI Europe Value has been over 3x that of MSCI Europe Growth year-to-date at the time of writing. Flows have followed a similar pattern, with the most bought sectoral European ETFs aligned to the Oil & Gas, Banks and Basic Resources sectors.

We recognise the drivers for this positioning change: a narrative of optimism corroborated with broad earnings beat and solid economic growth. However, we remain cautious on the narrative that we're seeing true regime change.

Inflationary pressures are beginning to come through. However, we believe these are caused by a specific combination of factors. Firstly, rising commodity prices, driven by a mothballing of productive capacity in 2020 as commodity companies anticipated weak demand. Now facing a significant resurgence in end markets such as construction, infrastructure and autos, a supply demand imbalance has occurred. This has led steel markets, for example, to profitability rates not seen since 2008 with corporates acting to take numerous price hikes. We see this as transitory, capacity will come back online but will take time. These pressures on pricing are for the near-term, not long-term.

Secondly, we are seeing inventory pressures causing a rise in input prices. Again, a reaction to demand resurging so quickly. Finally, we face a natural comparative effect from an exceptionally weak Q2 2020. Taken together this creates near-term inflationary pressure which, to our mind, will gradually normalise through time. However, this dynamic still has the capacity to create a mechanical de-rating of longer duration growth assets as the market looks to respond to the inflation data.

To that extent, we believe the market has already rotated quite far. Since the lows in March 2020, European cyclicals have outperformed European defensives by around 40%.

Whilst there has been clear cause for this based on earnings, not just narrative, we believe certain defensive businesses are now beginning to look attractive on both a relative and absolute valuation basis.

To quantify this rotation further at a stock level, we can look at the share price experience of European large-cap defensive stalwart Nestle as a proxy. Shares in Nestle have underperformed by 31% relative to the broader market since their highs in 2020, at the time of writing. During the post-Global Financial crisis market recovery, Nestle shares only reached 18% relative underperformance. We are beginning to see some strong valuation opportunities for long-term investors.

Our expectation for inflation in the longer-term remains muted. Fiscal policy, over monetary, has been the driver of near-term inflation. Inflation is likely to be allowed to overshoot in this cycle, but will fall back as policy support is removed.

The secular stagnation, to our mind, remains intact. Factors such as debt, demographics, inequality, digitisation and globalisation all continue to be deflationary. Even if we believe that the Covid-19 crisis and politics in recent years means globalisation may have peaked, we do not expect material deglobalisation. Goods prices likely remain a force for disinflation in developed economies.

With this view in mind, whilst our portfolios remain pro-cyclical, we continue to strongly consider durability of earnings and longer-term outlooks for businesses. This leads us to, at the margin, see more fresh money buy opportunities in somewhat less cyclical parts of the market

Reference to the names of each company mentioned in this communication is merely for explaining the investment strategy, and should not be construed as investment advice or investment recommendation of those companies.

Cyclicals posting material outperformance

European Cyclicals Index / European Defensives Index

Source: BlackRock, Bloomberg data March 2021

Fundamental Equities

α Expert insight

People	Profound curiosity, deep conviction
Purpose	Active edge, sustainable outcomes
Perspective	Astute, diverse, panoramic
Performance	Long-term lens, risk-aware results

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